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IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

NO. 74.

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, *et al.*,
Appellants,

vs.

THE UNITED STATES OF AMERICA, FEDERAL COMMUNICATIONS COMMISSION and NATIONAL ASSOCIATION OF RAILROAD AND UTILITIES COMMISSIONERS,
Respondents.

BRIEF FOR APPELLANTS, AMERICAN TELEPHONE AND TELEGRAPH COMPANY AND OTHERS.

Opinion Below

The opinion of the District Court (R. 561) is reported in 14 F. Supp. 121.

Jurisdiction

This is an appeal from the final decree of a specially constituted District Court for the Southern District of New York. The decree was entered March 24, 1936 (R. 584). The petition for appeal was filed and allowed April 6, 1936 (R. 586-596). Appellants have complied with paragraph 1 of Rule 12 by filing a statement of the grounds on which the jurisdiction of this Court is invoked.

Questions Presented

This is a suit to enjoin the enforcement of an order of the Federal Communications Commission prescribing a uniform system of accounts for telephone companies. Two of the provisions complained of were enjoined by the District Court and no appeal has been taken by the defendants.

The appellants here urge that three other provisions of the order are void.

1. The first prescribes the method of entering in the books of account purchases from another public utility of property already in use in public service, and requires recasting the books as to all such purchases in the past.

The Commission's order defines the "original cost" of such property as the cost to the company which owned it when first dedicated to the public use, and requires that the accounting company shall enter such "original cost" (estimated if not known) in its property investment accounts.

The difference between the actual or estimated "original cost", and the amount actually paid for the property by the accounting company, is required to be entered in an account labeled "Telephone Plant Acquisition Adjustment", which, the order provides, shall be disposed of, written off or amortized in such manner as the Commission may direct in the case of each separate purchase.

Although annual depreciation of telephone plant is treated as an operating expense entering into the computation of net operating income, the order forbids charging depreciation on the "Telephone Plant Acquisition Adjustment" account as an operating expense.

The appellants contend these provisions are void because:

(a) Broad as the discretion of the Commission may be, under the statute, it has no authority to prescribe a system of accounts which does not truly record the actual condition and actual transactions of a telephone company.

(b) Excluding a part of the cost of property from the investment accounts and placing it in an "adjustment" or suspense account which is subject to be written off immediately or later, in the discretion of the Commission, misstates the true property investment.

(c) Refusing to allow the companies to charge in the operating account annual depreciation on the part of the property cost placed in the adjustment account requires a false statement of net operating income.

(d) The statute authorizes the Commission to prescribe rules in accordance with which all telephone companies, or all within a class, shall keep their accounts. The requirement that part of the cost of property shall be placed in an adjustment account and disposed of, not in accordance with any rule, but as the Commission may direct in the case of each individual property acquisition, is not authorized by the statute.

(e) Accounts which truly record the facts of a company's own actual transactions and condition, such as actual cost of its property, are necessary for the management of its business and for the information of stockholders, prospective investors and tax collectors, as well as for rate making purposes. If additional information as to the transactions of prior owners is deemed helpful in establishing a ratebase, that can be ac-

complished by the use of supplemental records without excluding, as the prescribed system does, a correct record of the company's own transactions.

2. Another provision objected to is that which states all outlay for plant and operating expenses shall be reasonable and any payments in excess of "reasonable" amounts shall be charged against income and ignored in arriving at net operating income. This is coupled with the statutory provisions that punish as a criminal offense and by forfeitures any failure to keep the accounts as prescribed and provide for enforcement by civil process.

We contend that this provision is arbitrary, because it requires the accountant not to record what was paid, but what someone's opinion is as to what should have been paid.

It also is void because it demands obedience to a rule so vague as not to constitute a legal standard of conduct. The statute, punishing criminally failure to obey the order prescribing the form of accounts, contemplates that the order prescribing the forms shall be sufficiently definite so that a violation may be the subject of criminal proceeding. Under the Lever Act cases, applying the 5th amendment, a violation of this requirement could not be punished criminally. Therefore the provision is not authorized by the statute.

3. The third objection is to the classifications prescribed for physical property, as applied to spare plant. These provisions exclude from Account 100.3, covering "Property Held for Future Telephone Use", property not held for "imminent" use, and require it to be placed in Account 103, "Miscellaneous Physi-

cal Property", the depreciation, taxes and maintenance charges on which are not allowed in computing net operating income.

We contend that if the word "imminent" has its usual meaning, *i. e.*, "immediate", the regulation is void, as arbitrary, and if it has not that meaning, it is so vague as to be no guide to accountants and no rule, the disposition of each item of property held for future use being subject to the discretionary dictation of the Commission, and that such treatment is outside of the authority given by the statute, which is to prescribe a uniform system of accounts.

The same objection as to vagueness applies to the provisions which exclude an undeterminable amount of plant from Account 100.1, "Telephone Plant in Service," and require it to be placed in Account 100.3, "Property Held for Future Telephone Use."

The Statute

The provisions of the Communications Act of 1934, approved June 19, 1934 (48 Stat. L. 1064, 1078-1080), which give the Commission power to prescribe the forms of accounts are as follows:

> "Sec. 220. (a) The Commission may, in its discretion, *prescribe the forms* of any and all accounts, records and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys." (Italics supplied.)
>
> "(b) The Commission shall, as soon as practicable, prescribe for such carriers the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be

charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. Such carriers shall not, after the Commission has prescribed the classes of property for which depreciation charges may be included, charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or, after the Commission has prescribed percentages of depreciation, charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. * * *

"(d) In case of failure or refusal on the part of any such carrier to keep such accounts, records, and memoranda on the books and in the manner prescribed by the Commission, * * * such carrier shall forfeit to the United States the sum of $500 for each day of the continuance of each such offense.

"(g) After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect.

"(h) The Commission may classify carriers subject to this Act and prescribe different require-

ments under this section for different classes of carriers, and may, if it deems such action consistent with the public interest, except the carriers of any particular class or classes in any State from any of the requirements under this section in cases where such carriers are subject to State commission regulation with respect to matters to which this section relates."

Statement

On June 19, 1935, the Federal Communications Commission issued "Telephone Division Order No. 7-C" (R. 91-94) prescribing a Uniform System of Accounts for Telephone Companies, to take effect January 1, 1936 (R. 85-220).

On November 22, 1935, the American Telephone and Telegraph Company, and twenty-eight other telephone companies in the Bell System, brought this suit (R. 1) in the Southern District of New York, to enjoin the enforcement of the order. On December 6, 1935 (R. 222) seven other telephone companies filed a bill of complaint and were allowed to join in the suit (R. 237) as additional plaintiffs. Eight additional telephone companies intervened on December 16, 1935 (R. 240). The National Association of Railroad and Utilities Commissioners was allowed to intervene as a party defendant (R. 271). The case came on to be heard December 13, 1935, before a specially constituted District Court on the motion of the plaintiffs for a temporary restraining order and an interlocutory injunction (R. 306). At the conclusion of the hearing the parties stipulated (R. 552) to submit the case for final decree as well as for temporary restraining order and interlocutory injunction, upon the pleadings and the affidavits filed and to be filed by the parties, whereupon on December 28, 1935, the Court reserved decision on the motion for interlocutory in-

junction, and granted a stay of the Commission's order pending final decision (R. 559). The additional affidavits having been filed, the Court filed its opinion (R. 561) February 18, 1936, and its findings (R. 572) and decree (R. 584) March 24, 1936. The District Court permanently enjoined the enforcement of two requirements of the Commission's order. One of the requirements enjoined was that which prevented the companies from charging depreciation on that part of their telephone plants in Account 100.3, entitled "Property Held for Future Telephone Use" (R. 585). The system of accounts made no provision for charging depreciation on property in this account, although the time the property remained in this account was required to be included in its total life, on which the annual depreciation rate was based, thus preventing full depreciation from ever being charged. The other requirement enjoined (R. 585) was that which required that when one company had bought telephone property from another telephone company, which property had been received by the predecessor company as a gift or contribution, the purchasing company, notwithstanding it paid cash for the property, was required to record the contribution on its books as a liability (R. 570). The defendants have not appealed from this action of the Court below. All other relief asked for was denied, and this appeal by all the plaintiffs followed.

Beginning January 1, 1913, the accounts of telephone companies have been kept in accordance with a system prescribed by the Interstate Commerce Commission on December 10, 1912, and which, with minor amendments, remained in effect until January 1, 1933, on which date the Interstate Commerce Commission prescribed a revised system (R. 345-456). That sys-

tem is still in effect and will remain so (Sec. 604 (a) of the Communications Act) until superseded by a valid order of the Federal Communications Commission.

The Communications Act of June 19, 1934, transferred to the Communications Commission the authority over telephone companies previously vested in the Interstate Commerce Commission, effective when the Communications Commission organized, which it did July 11, 1934. Prior to that date the Interstate Commerce Commission had been holding hearings on proposed changes in the system of accounts for telephone companies and filed a report (R. 15-84) on July 9, 1934, definitely condemning as unsound substantially the same proposal as was later adopted by the Communications Commission, that when a telephone company purchased property from any utility company "the original cost" to the predecessor company first dedicating the property to public use should be entered by the purchaser in its plant accounts and the balance of the amount paid should be placed in an "adjustment" account to be disposed of as the Commission might direct.* Following the transfer of authority to the Communications Commission it issued the order of June 19, 1935, here complained of.

The facts relating to the three requirements of the order which are assailed on this appeal are set forth below.

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* The proposal rejected by the Interstate Commerce Commission differed from that adopted by the Federal Communications Commission in that it provided that the items in the adjustment account should be written off as "the commission having jurisdiction" might direct. The Interstate Commerce Commission said (R. 57) that "it may be remarked in passing" that this would involve an unauthorized delegation of power to state commissions, but it rejected the entire proposal for other reasons (R. 22, 28, 41, 43-46, 56-57).

Original Cost

Under the system now in effect all of a telephone company's investment in physical property is embraced in two balance sheet accounts, Account 100, "Telephone Plant", and Account 103, "Miscellaneous Physical Property" (R. 378-9). Account 100, "Telephone Plant", is subdivided into a series of accounts (the 200 series) known as telephone plant accounts, covering respectively, pole lines, cable, aerial wire, and other classes of plant. The telephone plant accounts also include account 278, "Undistributed Cost of Property", and Account 280, "Construction Work in Progress", and other items (R. 393). The sum of all the telephone plant accounts makes up the total of Account 100, "Telephone Plant".

The new system prescribed by the Communications Commission makes radical changes.

Account 103, "Miscellaneous Physical Property", is retained, but Account 100, "Telephone Plant", is abolished and three new balance sheet accounts are prescribed (R. 121) viz.,

100.1, Telephone Plant in Service
100.2, Telephone Plant Under Construction
100.3, Property Held for Future Telephone Use.

None of these accounts is to state the companies' own investment in the property, but instead must state the "original cost" of that property.

"Original cost" is defined as follows, Instruction 3-S. 1 (R. 101):

> "'Original cost' or 'cost', as applied to telephone plant, franchises, patent rights, and right-of-way, means the actual money cost of (or the current money value of any consideration other

than money exchanged for) property *at the time when it was first dedicated to the public use, whether by the accounting company or by a predecessor public utility.*" (Italics ours.)

The following instructions are also contained in the order:

"20. Purpose of telephone plant accounts. (A) The telephone plant accounts (201 to 277, inclusive) are designed to show the *original cost* (note Instruction 3-S. 1) of the company's telephone plant (note Instruction 3-BB), which ordinarily has a service life of more than one year * * * (R. 107). (Italics ours.)

"21. Telephone plant acquired. (A) When property in use in telephone service (note instructions 3-AA) is acquired, the amount of money actually paid (or the current money value of any consideration other than money exchanged) for the property (together with preliminary expenses incurred in connection with the acquisition) shall be charged to account 276, 'Telephone plant acquired'. (Note also account 139.)

"(B) The accounting for the acquisition of the plant shall then be completed as follows:

"(1) The original cost, estimated if not known, (note instruction 3-S. 1) of telephone plant, governmental franchises and other similar rights acquired shall be charged to the telephone plant accounts, account 100.2, 'Telephone plant under construction', and account 100.3, 'Property held for future telephone use', as appropriate, and credited to account 276. When the actual original cost cannot be determined and estimates are used, the company shall be prepared to furnish this

Commission with the particulars of such estimates.

* * * * * * * *

"(4) The amount remaining in account 276, 'Telephone Plant acquired', applicable to the plant acquired, shall upon completion of the entries provided in the foregoing paragraphs (1), (2), and (3), be debited or credited, as appropriate, to account 100.4, 'Telephone plant acquisition adjustment', except that when any amount thus chargeable to account 100.4 applies to duplicate or other telephone plant which will be retired by the vendee in the reconstruction of the acquired property and its consolidation with previously owned property, the accounting for the amount applicable to such plant shall be submitted to this Commission for consideration and approval. * * * (R. 108-109).

"100.1. Telephone plant in service. This account shall include the original cost (note instruction 3-S. 1) of the company's property used in telephone service at the date of the balance-sheet as classified under accounts 201 to 277, inclusive. (Note also instructions 3-AA, 20 and 21.) (R. 122.)

"100.2. Telephone plant under construction. (A) This account shall include the original cost (note instruction 3-S. 1) of construction of telephone plant not completed ready for service at the date of the balance-sheet. It shall include interest during construction, taxes during construction, and all other elements of cost of such construction work. (Note also instructions 20, 21, and 22.) * * * (R. 123.)

"100.3. Property held for future telephone use. (A) This account shall include the original

cost (note instruction 3-S. 1) of property owned and held for imminent use in telephone service under a definite plan for such use. * * * (R. 123.)

"100.4. Telephone plant acquisition adjustment. (A) This account shall include the difference between (a) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (b) the original cost (note instruction 3-S. 1) of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the property acquired, and amounts of contributions to the predecessor company or companies for construction and acquisition of such property. If the actual original cost is not known, the entries in this account shall be based upon an estimate of such cost. (Note also instruction 21.)

* * * * * * * *

"(C) The amounts recorded in this account with respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct. (Note also instruction 21.)" (R. 123-124.)

The net result of these rules is that when a telephone company has purchased physical property from another utility company, *the cost of that property to the company which first devoted it to public service, whether the vendor or a predecessor company,* is entered in Account 100.1, "Telephone Plant in Service", or Account 100.2, "Telephone Plant Under Construction", or Account 100.3, "Property Held for Future Telephone Use", as the case may be, and the differ-

ence between the "original cost" and what the accounting company paid for it, is to be entered in Account 100.4, the "adjustment" account, *to be disposed of or written off as the Commission may direct.* This requirement is not limited to sales between affiliates, but applies to all purchases.

The expert accountants who testified for the plaintiffs characterize this "adjustment" account as a mere suspense account, to be treated at all times as a deferred charge against surplus (R. 312, 320, 327-328, 338-339). Thus a part of the actual investment in property is removed from the property investment accounts on the balance sheet and placed in a suspense account which is characterized as something to be charged off, rather than as an investment. This is the situation even before any specific item is ordered to be written off. After any part of this account is written off a company's investment cannot be obtained by any combination of balances shown on the books.

There is no rule or principle prescribed for disposing of items in the "adjustment" account. There are no directions to accountants as to disposition of items therein. They are to be disposed of in accordance with the Commission's discretion in each particular instance, with no rule stated to guide it.

One further important fact remains respecting these property accounts. *The companies are forbidden to charge annual depreciation on any property in Account 100.4, "Telephone Plant Acquisition Adjustment."* (See Sections 220 (b) (g) of the Communications Act, Instruction 80 and paragraphs (A) and (C) of Instruction 81. R., 118-9. Instruction 82, R., 120.) By other provisions of the order, annual depreciation of physical property is to be charged in computing net annual operating income (R. 158), but property carried in Account 100.4 is excepted,

even while allowed to remain temporarily in that account, and of course, when written off as the Commission may immediately direct, the item disappears for good from the accounts. Omitting this depreciation from the annual statements of net operating revenue results in false and misleading statements to the public, stockholders and internal revenue agents. Thus the companies are not allowed to recover through depreciation charges their own investment in depreciable property, but must base their depreciation charges on the investment of some prior owner.

The requirements of the order are not limited to future transactions. The old accounts of the companies must be recast on the basis prescribed. Some of the plaintiffs have property, the prior ownership of which was scattered among hundreds of predecessor companies. This is commingled. The order requires that it be sorted out, tagged, and a different basis of accounting used, according to whether it was bought by the accounting company from a utility company or from a manufacturer (R. 335-336, 459, 462-467, 583).

Where actual cost to a predecessor utility is not known, its "estimated" cost is to be used.

The record shows beyond dispute that the expense of recasting the plant accounts on this "original cost" basis, will amount to several millions of dollars (R. 332, 340-341).

The Provision Respecting the Charging of Just and Reasonable Payments

Instruction 2(B.1) (R. 98) is as follows:

> "All charges to the accounts prescribed in this classification for telephone plant, income, operating revenues and operating expenses shall be

> just and reasonable and any payments by the Company in excess of such just and reasonable charges shall be included in account 323, 'Miscellaneous Income Charges'."

The statute makes it a penal offense to violate this instruction. (Communications Act of 1934, Sections 220 (d), 504, 220 (e), 220 (g), 501, 502.)

Every accounting entry for the purchase of property or for wages, salaries or any other expense, is to be made at the risk of prosecution.

Property Held For Future Use

The order of the Commission contains the following:

> "100.3 Property held for future telephone use. (A) This account shall include the original cost (note instruction 3-S.1) of *property owned and held for imminent use* in telephone service under a definite plan for such use" (R. 123). (Italics supplied.)

Thus, spare plant not being used in telephone service at the date of the balance sheet (Account 100.1, R. 122) and not under construction (Account 100.2, R. 123) must, if its use is not "imminent", be placed in Account 103, "Miscellaneous Physical Property" (R. 125).

The order does not permit taxes, maintenance charges or depreciation on "Miscellaneous Physical Property" to enter into computation of net operating income (Accounts 315 and 322, R. 162, Income Statement, R. 158, Items 7, 11 and 14). The word "imminent" is not defined. If given its ordinary meaning, "immediate", the result would be that spare plant provided in the exercise of good business judgment, to

supply service when needed, although not immediately for use, would be treated differently than plant in use and excluded from the operating accounts. If the word "imminent" is not given its ordinary meaning, it becomes so vague a term as to furnish no rule for accountants to act upon, and throws the whole subject into the field of decision by the Commission on the facts of each case.

Because of the nature of the telephone business, the same difficulty exists in determining whether certain portions of the spare plant are "used in telephone service at the date of the balance sheet," and so chargeable to Account 100.1, or are "held for imminent use" and chargeable to Account 100.3.

Specification of Errors

1. The District Court erred in refusing to enjoin the provisions of the Commission's order respecting "Original Cost," particularly in so far as it requires the difference between the amount paid for property by the accounting company and the cost to some prior owner to be entered in the adjustment account, to be charged off or disposed of as directed by the Commission, and to be excepted from charges for depreciation. Assignments of Error Nos. 1 to 9 and 23 to 31, inclusive (R. 587-593).

2. The District Court erred in refusing to enjoin the enforcement of Instruction 2(B.1) respecting just and reasonable outlay for property or expenses. Assignments of Error Nos. 10 to 14, inclusive, and 34 (R. 590, 593).

3. The District Court erred in refusing to enjoin the enforcement of the provisions for classification of physical property, including particularly the classifi-

cation based on "imminent" use, and the requirement that property not held for "imminent" future use should be placed in Account 103, Miscellaneous Physical Property (Assignments 14-18, R. 590-1).

4. The District Court erred in refusing to enjoin the enforcement of the whole order, on the ground that certain of the invalid provisions above mentioned and those it held void, are inseparable from the rest, and what remains is an incomplete and unworkable system of accounts. Assignments of Errors Nos. 20 to 22 inclusive and 35 (R. 591, 593).

Summary of Argument

I. The "original cost" provisions of the Commission's order are void. They are based on the fallacious theory that the cost of property to the public utility first devoting it to public use fixes its value for all purposes in the hands of succeeding owners.

They prevent telephone companies from recording their actual investment in their accounts, from recovering depreciation expense, which they actually incur, on their actual investment, and require them to base depreciation charges on the cost to a prior owner.

The discrimination in allowance of depreciation between property bought from a utility company and like property bought from others is wholly arbitrary.

The "original cost" provisions are unauthorized by statute. The difference between cost to the former owner and cost to the accounting company is to be disposed of in the discretion of the Commission. No rule or principle is prescribed for disposing of these items. The statute authorizes the Commission only to prescribe uniform rules. Here there is no rule

to guide a bookkeeper, or the action of the Commission. A direction by the Commission as to items in the Adjustment Account is not an interpretation of a rule. The provision in the statute authorizing the Commission to call for information on cost to former owners implies that the information shall be obtained from sources outside the accounts, not in them. The cost of recasting all accounts of property heretofore purchased from utilities would be enormous and an unreasonable burden.

The system prescribed by the Communications Commission has been rejected by the Interstate Commerce Commission, and held invalid by the courts of New York under a similar State statute.

II. The requirement in Instruction 2(B.1) that all charges for plant and operating expenses shall be "just and reasonable" and that all amounts paid for such purposes in excess of just and reasonable amounts shall be excluded from computation of net operating income and entered as "Miscellaneous Income Charges", is arbitrary and unauthorized by statute. It results in a false statement of net operating income, based on what the Commission may think should have been paid. It conceals the facts and actual operating expenses. The accounting company acts under peril of criminal prosecution if it enters what it has actually paid as a current operating expense. The penal provisions of the statute, coupled with the order, violate the Fifth Amendment, furnishing too vague a basis for criminal prosecution. The provision is obviously intended to enable the Commission to interfere in matters of management. The statute does not contemplate that the order prescribing accounts may be used as a

means or device to regulate the affairs of the telephone companies.

III. The classification of physical property is void. The requirement that under the account "Property Held for Future Telephone Use," may be placed only that held for imminent use is either arbitrary or void for indefiniteness.

If "imminent" means "immediate", the provision is void in excluding from computation of net operating income, maintenance, taxes and depreciation on property justifiably held for future but not immediate use. If the word "imminent" has not that connotation, then its meaning is too vague to form any guide to accountants and relegates decision on every item to the discretion of the Commission, and the provision is unauthorized by the statute, which contemplates a set of uniform rules, not individual directions by the Commission.

The dividing line between telephone plant in service and property held for future telephone use is likewise too vaguely defined to constitute a valid classification.

IV. The decisions of the courts are consistent with the appellants' contentions.

V. The system of accounts prescribed is incomplete and unworkable if the provisions complained of are stricken out, and the whole order should be enjoined, unless the Commission indicates its readiness to supply the defects before the new system is placed in effect.

Argument

I.

The "original cost" provisions are void.

That part of the Commission's order which requires property purchased from another utility to be carried in the companies' investment accounts at the amount it cost that former owner which first devoted it to public use, and which requires that the difference between that figure and the amount paid for it by the accounting company be placed in an adjustment account, to be disposed of, written off, or amortized as the Commission may direct, and which forbids an annual depreciation charge on that part of the purchase price in the adjustment account, obviously has its foundation in a theory that the cost to the predecessor company fixes the basis for rate making. No other explanation of these rules suggests itself.

Some authorities have striven for the rule that the prudent investment of the accounting company shall be adopted as the rate base. The theory that the cost to a former owner is to be used is one step farther away from anything recognized by decisions of the courts. To carry this theory to a logical conclusion, the Commission should have made a rule that the amount in the "adjustment" account should be immediately charged to surplus. In this respect the Commission lacked the courage of its convictions. Instead, it has attempted to avoid the issue by merely providing that amounts in the adjustment account shall be disposed of as the Commission may direct, without stating any principle on which it proposes to act. Its ultimate purpose may be carried out under

cover of this power. The effect of these provisions clearly tends to hamper the companies in maintaining records furnishing information for applying the established rules of rate making, but we do not contend that in this respect the order fixes a binding rate base. Notwithstanding the accounts are kept as required, it would be open to the companies in a rate case to disregard the plant accounts as recorded, and establish, if they can, the true rate base. This has been made clear in *Norfolk & Western Railway Co.* v. *United States,* 287 U. S. 134. Our attack upon the order is on different grounds. We contend:

1. The system prescribed is such as to prevent a company's investment accounts from showing its actual investment.

The original cost provisions require the plaintiffs' property investment accounts to be kept on a basis which will reflect neither the fact of their actual investment in their property nor its value, but which will conceal the actual investment and substitute, in the case of purchased property, the investment of a prior owner (estimated it not known). Sound accounting requires that a company's accounts shall show its own actual costs, and not the costs of some prior owner, or what some one thinks its costs should have been. The accountants who testified for the plaintiffs all agree that cost in accordance with established accounting practice is an individual matter. The records of an individual concern must show what its own costs are, never those of a competitor nor what its own costs might have been had other conditions prevailed or other decisions been made than those which were made. In other words, the record of each concern must provide an accurate his-

tory of what actually took place in that concern. Any other system is misleading and does not truly reflect the financial position (R. 309, 311, 319, 326).

The defendants contend that a company's plant investment may always be ascertained by adding together accounts

100.1, Telephone Plant in Service;
100.2, Telephone Plant Under Construction;
100.3, Property Held for Future Telephone Use; and
100.4, Telephone Plant Acquisition Adjustment.

If the Commission never exercises its power to order any item in Account 100.4 written off, this would be true, but the argument is not entirely frank. These items may be ordered written off immediately. Presumably they will be, sooner or later. It is no answer for the Commission to say the accounts will show total plant investment if the Commission does not exercise the powers it reserves. Furthermore, the "adjustment" account, 100.4, is merely a suspense account, with some further disposition in sight. The plaintiffs' accountants truly state that it is merely a deferred charge against surplus, that no careful accountant could fail to immediately treat it as such, and in all financial statements set up a reserve in equal amount. One says:

> "In truth, the balance shown under account 100.4 under the new system is a deferred charge, since the Commission may make it so at any time. Because of this uncertainty it is for all practical purposes an offset against surplus. A balance sheet which would fail to call specific attention on its face to the fact that the Commission *must* extinguish this item and may ex-

> tinguish it immediately by a write-off is incomplete and misleading, * * *" (R. 320).

What goes into the adjustment account is definitely removed from the investment accounts. The defendants will hardly contend that this order contemplates that the Commission will dispose of items in the adjustment account by transferring them to the investment accounts. The order specifically limits Accounts 100.1, 100.2 and 100.3 to the amounts of "original costs". There is no other property account to which they can be transferred. They stay where they are, or are written off. The fact, next referred to, that while in the adjustment account these items of cost of plant are not to be annually depreciated, confirms the fact that they are regarded as finally out of the investment column.

2. The "original cost" provisions are arbitrary because they prevent plaintiffs from recovering the depreciation expense which they actually incur.

It is undisputed that, under the order, charging depreciation on that portion of plaintiffs' investment which is included in Account 100.4 is forbidden, so that even if the Commission delays the write off for a longer or shorter period, and allows part of the cost of depreciable property to remain in that account, it may not be the basis of a depreciation charge.

In *Kansas City Southern Railway* v. *United States*, 231 U. S. 423, 448, the Court refers to depreciation as "an inevitable fact which no system of accounts can properly ignore."

The defendants contend that under the reserved power to amortize items in Account 100.4, it may, in its discretion, order them amortized by charges to

operating expenses. Here, again, they are not quite frank. Taking the order as a whole, it is obvious that there is no intention of treating anything but "original cost" as an investment or a basis for depreciation. Furthermore, the Commission should not have any discretion in the matter. If depreciation charges are to be based on cost there should be an absolute rule for using a company's own cost as the basis, and not the cost of another company. The system as it stands is illegal. It is no answer to say that the wrong may be corrected by a discretionary order in a particular case.

This system of accounts does have the effect of preventing plaintiffs from charging depreciation on part of their actual investment. A company is not allowed to recover, through depreciation charges, its own investment in property which is being used up, *but must base its depreciation charges on the investment of that former owner who first placed it in public service.*

Although in a rate case annual depreciation is based on value (*United Railways* v. *West,* 280 U. S. 234), it is not possible as a matter of current bookkeeping to make entries on that basis, as "value" may shift from time to time, and the universal practice is to use cost to the accounting company as a basis (see notes 23, 24 and 25, 280 U. S., pp. 266-270). In *Telephone and Railroad Depreciation Charges,* 177 I. C. C. 351, the Commission said at page 381:

> "It is not essential that the accounts should correspond in all respects with the facts which may be controlling in a confiscation case. In such a case the fact with respect to property, which is ascertained is its fair value, but we know of no system of accounts which undertakes to dis-

close this fact with respect to physical property. On the contrary, such property is normally stated in the investment account at cost. In determining whether confiscation has been or will be accomplished, the court will make allowance for unnecessary or unjustifiable operating expenses, but all such expenditures must be shown in the accounts. Accounting is not an exact science but a practical art which has evolved through a gradual process of trial and error and the application of sound judgment to experience."

The Commission also said at page 374:

"The practice which we have followed of basing depreciation charges upon original cost to the accounting company is general in this country."

The denial of the right to charge depreciation on that part of the cost in Account 100.4, is arbitrary for another reason. The property is classified for the purpose of fixing depreciation charges, not according to its character, or susceptibility to depreciation, but according to whether it was or was not bought from another utility company. If a telephone company buys poles from a timber company and builds a pole line, annual depreciation will be charged on the cost. If another line of poles, precisely like the first, is bought from an electric light company, the basis of depreciation charges is not the price paid, but the cost to a former owner. If a telephone company buys a building from a real estate company depreciation is charged on the price paid, but if it buys an identical building from another telephone company the depreciation base is that company's (or its predecessor's) cost. So with all classes of depreciable property.

3. The rules require a false and misleading statement of net operating income.

The result of these depreciation provisions is to falsify the income statement (R. 158-159). The system requires that allowed depreciation charges on physical property enter into the computation of net operating income, income available for fixed charges and surplus. By denying depreciation on part of the cost of depreciable property, the system falsifies the annual statements and requires the companies to make misleading statements in all these respects.

A fundamental objection to this system is that it has an eye only for a new theory as to a rate base and requires the companies to keep their accounts on that basis. It requires a company to keep its books on a basis which ignores its own actual transactions and falsifies its financial condition.

It ignores the fact that the accounts are not only for use in rate making, but for the information of the management, the shareholders, the investing public and the income tax collector. Accounts kept as this order prescribes would mislead all of those interested in what the operations of the companies actually are.

4. The original cost provisions are unauthorized by the statute in that they fail to prescribe any rule for the disposition of items in Account 100.4, but leave each individual accounting entry to the unfettered discretion of the Commission.

This objection, not the least formidable among those presented, is directed at that provision relating to disposing of items in Account 100.4. Under the head of "Telephone Plant Acquisition Adjustment" we find the following:

"The amounts recorded in this account with

> respect to each property acquisition shall be disposed of, written off, or provision shall be made for the amortization thereof in such manner as this Commission may direct" (R. 124).

Account 100.4, as we have shown and this rule plainly discloses, is a mere suspense account, in which part of the cost of property is to be placed to remain only temporarily before being carried to its final resting place.

No rule is laid down to govern the disposition of these items. The accountant's hand is stayed until the Commission acts in respect of each item. The statute gives no authority for such a method. It provides that:

> "The Commission may, in its discretion, *prescribe the forms* of any and all accounts, records and memoranda to be kept by carriers subject to this Act, including the accounts, records and memoranda of the movement of traffic as well as of the receipts and expenditures of moneys." (Italics supplied.)

In *Kansas City Southern Ry.* v. *United States,* 231 U. S. 423, the railroad urged that the Commission had power to prescribe the forms but not the substance. This Court rejected the distinction, saying, at page 443, that

> "* * * since, * * * uniformity in accounting is dependent upon the adoption and enforcement of *precise classification,* the authority to define the terms of the classification necessarily follows." (Italics ours.)

The Communications Act of 1934 authorizes a departure from uniformity only to the extent that the

Commission may classify carriers subject to this Act and prescribe different requirements under this section for different classes of carriers (Section 220 (h)).

The statute plainly requires the Commission to prescribe the forms of the accounts, not to reserve to itself the disposition of each particular item. It contemplates a system of accounts furnishing a complete guide to the accountant, a system of general rules, applicable alike to all telephone companies or all within a class. It falls short of attempting to delegate to the Commission the power to apply its discretion to the entry of particular items, in the absence of any rule. If the Commission in respect to any substantial part of a company's transactions may fail to prescribe such a rule and reserve the power to direct entries, in its discretion, then it may do so with respect to all entries, and the statute would be satisfied by an order merely providing that all entries shall be made as the Commission, in its discretion, may direct. Clearly this is beyond its authority.

The clause in the Communications Act, requiring six months' "notice of alterations by the Commission in the required manner or form of keeping accounts" is inconsistent with a grant of authority to establish no rule but to dictate individual entries in its discretion. The understanding the Interstate Commerce Commission had of its powers under a like statute is clearly shown in *St. Paul & Puget Sound Accounts*, 29 I. C. C. 508.

It has been suggested that the Interstate Commerce Commission has made a practice of issuing directions as to individual items. In a sense that is true, but a search of its reports confirms the assertion that in so doing, it was *merely interpreting and applying rules stated in its orders prescribing the forms of ac-*

counts. These interpretations have usually resulted from letters of inquiry from carriers or instances of apparent violation of regulations, and directions to make specific entries in accordance with these interpretations have usually been contained in letters or reports, as distinguished from orders. If such a direction is made and disobeyed, the prosecution would be for violation of the general regulation, not of the direction in the letter or report.

In the few cases where the Interstate Commerce Commission has by order directed a specific entry, the order has either been for the enforcement of a condition as to accounting which the Commission had previously attached to an order authorizing a carrier to acquire a property or issue securities, or has been in furtherance of existing general regulations as construed by the Commission. A number of these orders have resulted from fact finding which brought a transaction within the scope of an existing regulation.

See:

St. Paul & Puget Sound Accounts, 29 I. C. C. 508;

Reorganization & Control of Atlanta, Birmingham & Atlantic Ry., 117 I. C. C. 181; s. c. 117 I. C. C. 439; s. c. 158 I. C. C. 6;

Atlanta, Birmingham & Coast R. R. Co. v. *U. S.,* 28 F. (2d) 885; 37 F. (2d) 401; 282 U. S. 522; 201 I. C. C. 645; 12 F. Supp. 782; 296 U. S. 33;

Chesapeake & Ohio Case, 153 I. C. C. 9; 190 I. C. C. 382; 5 F. Supp. 7;

Norfolk & Western Case, 171 I. C. C. 557; 52 F. (2d) 967;

Norfolk & Western Ry. v. *U. S.,* 287 U. S. 134;

Saratoga & Encampment Valley Case, 192 I. C. C. 719;
New York Telephone Case, 188 I. C. C. 83;
Acquisition of Line by Jacksonville, Gainesville & Gulf Ry., 124 I. C. C. 623;
Acquisition of Line by Southern Pac. Co., 131 I. C. C. 726;
Control of Sewell Valley R. R. Co., 138 I. C. C. 85;
Acquisition of Lines by Gulf, Mobile & Northern, 154 I. C. C. 479;
C., M., St. P. & Pacific R. R. Co. Acquisition, 158 I. C. C. 770;
Rock Island System Consolidation, 193 I. C. C. 395;
Texas Midland R. R., 75 I. C. C. 1, 43.

Furthermore, there was no provision in the Interstate Commerce Act, as there is in the Communications Act, that six months' notice must be given of changes in the form of accounts. If a rule of the Interstate Commerce Commission was vague, a ruling by the Interstate Commerce Commission in a particular case could have the effect of an order prescribing a new rule.

5. The provision of the Communications Act authorizing the Commission to ask for information about cost to prior owners, supports our contention:

In the Court below, defendants relied on Section 213(c) of the Communications Act authorizing the Commission to require any carrier to file with the Commission a statement of "original cost at the time of dedication to the public use" of all or any part of the property of the carrier. This is found in the

section of the Act having to do with valuations and is one of the provisions in aid of valuations.

Their argument was that since the Commission could call for a statement of the information, it could require the companies' investment accounts to be carried on that basis. We draw the opposite inference. If the Congress had intended that the accounts might be kept on that basis it would have said so. The fact the information authorized to be requested is in the form of a separate statement, implies that it is to be collected from other available sources than the companies' current accounts. This conclusion is confirmed by Section 219(a) of the Act which requires the annual report to show the "cost" of the carrier's property. This cost must be derived from the accounts, and is obviously the cost to the accounting company.

6. Account 278 prescribed by the Interstate Commerce Commission is quite unlike the ones here assailed.

In the Court below, the defendants referred to Account 278 of the present system prescribed by the Interstate Commerce Commission as performing substantially the same function as Account 100.4 prescribed by the Communications Commission. There are great differences in principle and effect.

Account 278 of the present system represents the difference between the amount paid for property and its *structural value* (reproduction cost new less depreciation) at the time of purchase. It has nothing to do with cost to any prior owner. Where the amount paid for property is more than its structural value when bought, the excess is excluded from the depreciable property accounts and placed in Account

278, the theory being that if more is paid for property than the appraised value of its physical elements, the excess must have been paid for intangible elements, such as going value, which are not regarded as subject to depreciation (R. 45-46, 404).

Important differences between the treatment of Account 278 in the present system and Account 100.4 are as follows:

The present system permits the company to recover through depreciation charges the reproduction cost less depreciation existing at date of purchase, of purchased property. The system of the Communications Commission permits it to recover only what the property cost some former owner (less depreciation existing at date of purchase).

The present system does not subject Account 278 to being disposed of, written off or amortized at the will of the Commission. The company is permitted to write it off or amortize it but is not required to.

There is nothing in the present system which characterizes this account as a worthless or dubious asset. On the contrary, the balance in Account 278 is a part of the amount appearing in Account 100 as the company's total investment in telephone plant.

7. The cost of recasting the accounts on the basis prescribed is unreasonably burdensome.

The order requires recasting the accounts for all past transactions. The amount of property purchased by plaintiffs from other utilities is large. Since 1915 the plaintiffs have so purchased approximately $750,000,000 of property, involving well over one hundred thousand transactions. This property is commingled with other property not acquired from utility companies. Countless items of both kinds have been

retired, and identification would require search of detailed records of nearly the entire volume of purchased property, including that retired as well as that in existence (R. 335-6, 340-1).

Similar situations exist in respect of the additional and intervening plaintiffs.

The cost of this work would be several million dollars (R. 341).

The defendants answer that this expense may be imposed by the Commission under Section 213 (c). But the information as to actual (or estimated) cost to prior owners when obtained is of such doubtful value, even in a rate case as bearing on present worth of property, as to justify doubt as to whether the complete information required to recast the accounts could or would be asked for.

8. The system prescribed by the Commission has been rejected by the Interstate Commerce Commission as unsound, and by the New York courts as unauthorized by a state statute like the Communications Act of 1934.

The proposal to require costs to some prior owner to be set up in the plant accounts and the difference between that and the price paid by the accounting company to be placed in a suspense account to be dealt with by the Commission, was the subject of extended hearings by the Interstate Commerce Commission. On July 9, 1934, it filed its report rejecting the proposal as unsound (R. 22, 28, 41, 43-46, 56-57).

In the Court below the defendants pointed out (R. 543) and relied upon the fact that the Interstate Commerce Commission's definition of "original cost" was practically the same as that of the defendant Commission. It is true that in its report in the proceedings for a modification of the "First Revised

Issue", the Interstate Commerce Commission adopted a definition of original cost similar to the one involved in this case (R. 41). But the report provided that the term as thus defined be used only in the accounting for cost of franchises, and it left the accounting for telephone plant and other property on exactly the same basis as before. As franchises had always been accounted for on this basis, the adoption of this definition in the Interstate Commerce Commission's report had no effect whatever upon the accounting. Plaintiffs do not object to this as a definition, provided it is not used in prescribing the basis upon which they shall keep their property accounts. The Interstate Commerce Commission rejected the proposal that they be required to keep their property accounts on the basis of original cost as thus defined.

Public Service Law of New York, §66, subd. 4 grants to the Public Service Commission power to prescribe uniform methods of keeping accounts. The system prescribed by the Commission contained provisions defining and dealing with "original cost", like those in the order of the Communications Commission. Definition 31 defined "original cost" as the cost when first dedicated to public use. Account 143 was entitled "Suspense to be Amortized". In it was required to be placed any excess cost to the accounting company over the amount the property cost the first public utility owner. The disposal of items in this suspense account was covered by an instruction that they "shall be written off over such period and in such manner as the Commission by order may prescribe." The Appellate Division (*New York Edison Co. et al.* v. *Maltbie,* 244 App. Div. 685, 281 N. Y. S. 223), held these provisions void, as outside the authority granted by the statute: that the statute did

not vest in the Commission power to order a corporation to write off its books a loss it has not sustained; that actual cost is a relevant fact and that a corporation may not be compelled to make entries to conceal a relevant fact. The Court also said:

> "The petitioners argue, and with high judicial authority, that the books of a utility corporation are not kept solely for the information or benefit of the Commission; that stockholders, bond owners, the investing public and rate payers are interested; also that corporate financing is done upon the basis of book values."

The Court of Appeals of New York affirmed this decision. *Matter of New York Edison Co.* v. *Maltbie,* 271 N. Y. 103.

II.

The provision respecting the charging of just and reasonable payments is void.

This is contained in Instruction 2(B.1) (R. 98) which is as follows:

> "All charges to the accounts prescribed in this classification for telephone plant, income, operating revenues and operating expenses shall be just and reasonable and any payments by the Company in excess of such just and reasonable charges shall be included in account 323, 'Miscellaneous Income Charges'."

This requirement is arbitrary and unauthorized by the statute. It requires the accounts to record what in someone's judgment should have been spent rather than what was spent. The excess must be charged

to Account 323, "Miscellaneous Income Charges", and excluded from the computation of net operating income (R. 158, Items 7 and 15).

Net operating income is one of the most vital items in the companies' statements, of wide interest to investors and others. Whether an outlay of an operating expense was reasonable or unreasonable, being paid and non-recoverable, it nevertheless is an outlay which should enter into the computation of net operating income, and any system of accounts which forces a false statement of net operating income and conceals the truth as to the actual operating expenses, is arbitrary.

The statute, it will be remembered, makes it a penal offense for any company to fail to comply with the order prescribing the form of accounts. The accounting company acts at the peril of criminal prosecution in recording every item of outlay for property, wages, salaries, or other expenses. There may be the widest difference of opinion as to what is just and reasonable, but a company will hardly pay more for property or services than it believes they are worth. Presumably no part of any outlay would be treated by it, in the first instance, as unreasonable and charged to Account 323. It is then subject to prosecution, if the public authorities have a different opinion as to the reasonableness of the outlay. Of course, these provisions have the effect of denying due process under the Fifth Amendment, because there is an exaction of obedience to a rule so vague and indefinite as to be no standard at all.

United States v. *Cohen Grocery Co.*, 255 U. S. 81;

Tedrow v. *Lewis & Son Co.*, 255 U. S. 98;

Small Co. v. *American Sugar Refining Co.*, 267 U. S. 233;

Connally v. *General Construction Co.*, 269 U. S. 385;
Cline v. *Frink Dairy Co.*, 274 U. S. 445.

In the cases cited, both the penal provisions and the vague standard were contained in the statute. Here the penal provisions are in the statute and the vague and indefinite standard is in the order of the Commission. If this affords any basis for distinction, the answer is that the statute contemplates that the order prescribing the system of accounting shall be sufficiently definite that violations of it may be punished criminally, and any provision of the order for accounts which is so vague that violation of it may not be prosecuted is not authorized by the statute.

In a recent case before the Wisconsin Public Service Commission* an identical provision was assailed and stricken out by the Commission.

The obvious purpose of the provision is to allow the Commission, through fear of criminal prosecution, to impose its judgment on the company as to the reasonableness of every outlay. The statute authorizing the Commission to prescribe the form of accounts, gives no power to interfere in management, or require recording what the Commission may think should have been done, instead of what actually occurred.** There is nothing in the statute or the order which provides for any hearings or decision by the Commission as to the reasonableness of outlay. If, as defendants suggest, its advice should be sought,

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* In the *Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities*, 2-U-902, decided December 20, 1935.

** See *New York Edison Co.* v. *Maltbie*, 244 App. Div. 685; 281 N. Y. S. 223 at page 226; also *People ex rel. New York Ry. Co.* v. *Public Service Commission*, 223 N. Y. 373, at page 378.

and not followed, the prosecution would be for violation of the original order prescribing the form of accounts. That provision is a plain usurpation of the right of management.

III.

The classification of physical property is void.

An important part of the property of all the companies consists of spare telephone plant, provided to meet additional demands for service in the most economical manner.

Under the Interstate Commerce Commission's system (now in effect) this property, as well as the telephone plant in use, is included in Account 100, Telephone Plant,* and the expense of its maintenance, depreciation, insurance and taxes is included in operating expenses and operating taxes and is considered in computing net operating income. Account 100, Telephone Plant, is one of the two main accounts into which the entire physical property is divided by the system now in effect. The other is Account 103, Miscellaneous Physical Property. The latter includes property "not held incident to the company's telephone operations", such as electric light plants or manufacturing plants, and also includes land, with the buildings and improvements thereon, which the company has acquired and is holding without any definite plan for use in telephone service or which has been retired

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* The words are "property used or held under a definite plan for telephone service" (R. 378). Of course all spare plant is held under a definite plan for use in telephone service when needed. Property such as land purchased for an indefinite possible future use, or property which has been finally retired from service, so as to be excluded from Account 100, is not considered spare plant.

from telephone service (R. 379, 59). What the Interstate Commerce Commission's system really does is to divide the property into two classes, telephone property and non-telephone property. It then provides that all expenses and taxes incurred in connection with the property in Account 103, "Miscellaneous Physical property," as well as the income therefrom, shall be excluded from the computation of net operating income.* This is, of course, entirely proper, since the property in this account, under the present system, is not held incident to the company's telephone operations.

The new system, like the existing one, provides that maintenance, depreciation, insurance and taxes on "Miscellaneous Physical Property" shall be ignored in arriving at net operating income.** But it differs radically from the existing system in that it classifies as "Miscellaneous Physical Property" all of the spare telephone plant which the companies are holding incident to their telephone operations, unless its use is "imminent". The new system divides the property into four accounts. These are:

100.1—Telephone Plant in Service. This includes the company's property "used in telephone service at the date of the balance-sheet" (R. 122).

100.2—Telephone Plant Under Construction. This includes plant "not completed ready for service" (R. 123).

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* See Accounts 315 and 322 of the present system (R. 409-410) and items 2, 6, 7, 11 and 14 of the Income Statement (R. 406).

** See Accounts 315 and 322 (R. 162) and lines 2, 6, 7, 11 and 14 of the Income Statement (R. 158).

100.3—Property Held for Future Telephone Use. This includes property "held for imminent use in telephone service" under a definite plan for such use (R. 123).

103—Miscellaneous Physical Property. This includes the company's physical property other than that included in the other three accounts, *i. e.*, it includes telephone property held for future use (under a definite plan or otherwise) if the future use is not imminent, as well as all non-telephone property (R. 125).

Thus plant which is not being "used in telephone service" and is not under construction, must go into either Account 100.3, "Property Held for Future Telephone Use" or into Account 103, "Miscellaneous Physical Property"—into the former if its use is "imminent", otherwise into the latter. The dividing line between these two accounts depends on the construction of the word "imminent".

What is meant by the word "imminent"?

According to the dictionaries and the courts, an event is imminent if it "threatens to occur immediately", is "near at hand", or "on the point of beginning". *Webster's International Dictionary; The Queen of the Pacific,* 25 Fed. 610; *Eckhardt* v. *City of Buffalo,* 19 App. Div. 1; *State* v. *Gateway Mortuaries,* 87 Mont. 225; *Smith* v. *City Ice & Delivery Co.,* 117 Kan. 485; *Julius Kessler & Co.* v. *Southern Ry. Co.,* 200 Ky. 713; *Pierce* v. *C. H. Bidwell Thresher Co.,* 158 Mich. 356.

The Commission can hardly have used the word in that sense. If it did, items in Account 100.3, Property Held for Future Telephone Use, would have to be transferred to Account 100.1, Telephone Plant in Service, almost before the ink dried on the first entry,

and property held for future telephone use would have to be placed in Account 103, Miscellaneous Physical Property, if not intended for immediate use, although necessarily provided for use in the future, in the performance of the duty to be ready to supply service, and while in Account 103 no costs of its maintenance, taxes or depreciation could be considered in computing net operating income. Such a requirement would obviously be arbitrary and grossly unreasonable.

If "imminent" does not mean "immediate" or "on the point of beginning", what is its meaning?

There will then be the widest difference of opinion as to whether the use of property is imminent. The word is too vague to define an accounting classification. All of the accounting experts for the plaintiffs so characterize it (R. 314-315, 322-323, 329, 341), and the experts for the defendants attempt no defense or explanation.* A rule depending on the construction of this word is so vague as to be no rule at all.

There is no reason why these important classifications cannot be made reasonably definite. It appears that instead of doing this the Commission has purposely made these classifications vague and has made the requirement, which defendants vigorously stress in this connection (R. 295, 491), that doubtful cases shall be submitted to it "for consideration and decision" (R. 104). Where the classifications are so vague that most cases are doubtful this will amount, in practical effect, to the dictation of individual accounting entries in the Commission's discretion. It

* The Interstate Commerce Commission rejected the proposal of certain state commissions to place telephone plant in the Miscellaneous Physical Property account unless there was a definite plan for its use "within one year" (R. 42, 69). The words "within one year" are less vague than "imminent", although both are based on *predictions* rather than upon factual situations.

is identical in principle with the Commission's proposal to determine whether an expenditure is just and reasonable by an "interpretation" in each individual case. It amounts to the same thing as the requirement that the items in the Telephone Plant Acquisition Adjustment account shall be written off as the Commission may direct in each instance. There the Commission explicitly undertakes to dictate individual accounting entries in the absence of rules, while here and in the case of the "just and reasonable payments" it proposes to do the same thing under guise of interpreting rules so vague as to be no rules at all.

The Commission is without authority to direct accounting entries in this manner. Its authority is to prescribe rules applicable alike to all carriers or to all within a class (Section 220 h). This court has said that one of the prime purposes of prescribed accounting for carriers is uniformity (*Norfolk and Western Ry. Co.* v. *United States,* 287 U. S. 134, 140) and that "uniformity in accounting is dependent upon the adoption and enforcement of precise classification" (*Kansas City Southern Ry. Co.* v. *United States,* 231 U. S. 423, 443). There has been no attempt at precise classification here. We concede that complete precision is not always attainable and that any classification may require interpretation when unusual or unforeseen cases arise, but this is no excuse for making the classification so vague and undefinable that a separate fiat may be made in each case under guise of an "interpretation" applicable to the facts of that case. This is the antithesis of uniformity.

The meaning of the word "imminent", when applied as here to property held for *future* use, is so

uncertain that almost any entry made by a company's accountants could be challenged by the Commission. The Commission would then settle the entry by an "interpretation". By its "interpretation" (*e. g.*, by saying that the use of a particular cable or section of switchboard is imminent or the reverse) the Commission will say that the vague accounting rule requires the entry in question to be made in a particular way. The company must then follow this advice or risk prosecution, but the prosecution would be for violation of the original vague rule. If punishment under this vague rule were valid the Commission could thus compel the company, through fear of penalties, to make individual accounting entries in accordance with the Commission's discretion in each instance. But if punishment would be invalid, on the ground that exaction of obedience to a standard so vague is a denial of due process,* then the accounting rule is clearly invalid.

We can perceive no purpose to be served by this accounting scheme unless it is regarded as an attempt to pre-judge the issue of used and useful property in rate cases, or as a means of enabling the Commission to substitute its judgment for that of the management as to how much spare plant shall be provided for fluctuations in traffic and for growth, compulsion being exercised by compelling the companies to ignore, in computing net operating income, any spare plant in excess of that deemed desirable by the Commission. These are not proper functions of an accounting system.

The system is likewise vague as to the property to be included in Account 100.1, Telephone Plant in Service. This is to embrace property "used in tele-

* See cases cited on pages 37-8 of this brief.

phone service at the date of the balance sheet". Superficially this appears to be definite, but because of the nature of telephone plant and the conditions of its use it is too vague to constitute a workable basis for differentiating between this account, and Account 100.3 and Account 103. Much of the property of every telephone company consists of large units which are made up of smaller units. For example, switchboards consist of large sections, some of which often are unused. Is the entire switchboard "used in telephone service," and thus to be charged to Account 100.1, or are the unused sections to be considered as held for future use and charged to Account 100.3 or Account 103, depending on whether the future use is imminent? An underground conduit consists of a number of ducts, only a part of which initially contains cables; the cables themselves consist of many pairs of fine wires, some of which are spares; buildings initially contain vacant floor space. There is the same question as to each. Experience in rate cases has shown it to be a controversial one. The system of accounts leaves it unanswered (R. 342, 314, 322, 329, 333). It would be easy to answer. *While the system was in tentative form plaintiffs specifically asked the Commission to answer this question and incorporate the answer in the system, but their request was ignored* (R. 555-557).

In this litigation the Commission's witnesses have given their interpretation of the words "used in telephone service" as applied to spare plant. Thus the witness Colbert says that where any wires in a cable are in use the entire cable is "used" and should be charged to Account 100.1, Telephone Plant in Service, and we understand him to mean that the same is true of spare plant generally, such as idle

sections of switchboards, vacant ducts in conduits and vacant floor space in buildings (R. 528-9, 530). However, other witnesses for the Commission take a different view. Its chief accountant, Norfleet, says that only "necessary" spare plant is to be included in Account 100.1 (R. 481). His idea apparently is that the Commission will decide how much spare plant is necessary in each case. Its accountant, Rains, indicates that the companies should not attempt to interpret these classifications themselves and suggests no interpretation of his own. He apparently realizes the patent uncertainty and thinks the companies should ask the Commission what to do whenever in doubt as to an entry. He thus admits there is no rule to guide accountants (R. 491). If the Commission would change its system of accounts to conform to the interpretation of the witness Colbert, as we have stated it, appellants would be satisfied on this point.* This would not, however affect the ambiguous dividing line between Accounts 100.3 and 103, resulting from use of the word "imminent," as to which all of defendants' witnesses are silent.

The Wisconsin Commission, when these identical provisions were attacked in a proceeding before it, disposed of the entire question of the classification of physical property in a manner which was acceptable to the companies and should satisfy every legitimate need of regulation. That Commission determined that Account 100.1 should include spare

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* While the system of accounts was still in tentative form, plaintiffs formally requested, in writing, that it be changed to conform to this interpretation, but this request was refused (R. 555-556).

plant such as unused circuits in a cable, as well as plant temporarily out of service. It said:

> "It appears that this matter is dependent upon the interpretation of the word 'used' in the text of account 100.1, Telephone Plant in Service. This account includes the original cost of the company's plant used in telephone service. The term 'used' should be interpreted broadly. For accounting purposes, plant will be considered as used even though it is not giving service to the full extent of its capacity. The cost of a cable, for example, should be included in account 100.1, even though some of the circuits are not rendering service. This means that for accounting purposes, spare plant, that is, plant that is used, though not to its full capacity, is includable in account 100.1, Telephone Plant in Service. We also interpret the term 'used' in account 100.1 as including, for accounting purposes, plant which is temporarily out of service."

Such a clarification of Account 100.1 would satisfy appellants, but we have no assurance it will be so interpreted, because, though requested (R. 555-6), the Communications Commission has refused to modify or clarify the definition.

The Wisconsin Commission also modified the definition of Account 100.3 to read as follows:

> "This account shall include the original cost (note instruction 3 S.1) of property owned and held for future telephone use."

It struck out the word "imminent".

Under the system thus construed and amended all plant which is used, including its spare capacity, goes into Account 100.1, Telephone Plant in Service;

all plant which is held for future telephone use goes into Account 100.3, Property Held for Future Telephone Use, regardless of the imminence of its use; and Account 103, Miscellaneous Physical Property, includes only non-telephone property.

IV.

The decisions of this Court are consistent in every respect with appellants' contentions.

The decisions of this Court have been well summarized in *Chesapeake and Ohio Ry. Co.* v. *United States,* 5 F. Supp, 7, 10, where the Court said:

> "* * * The order complained of requires the carrier to keep its accounts in a particular manner, and, in effect, if its contention is sound, denies it the right to maintain its equipment out of earnings, requires it artificially to inflate and enlarge its investment and decrease its income accounts, and keep its books upon an unreal and untrue basis. The only ground upon which it can be said that the carrier suffers no legal injury as a result of an order having such effect, is that mere accounting entries are involved and that, in the absence of immediate pecuniary or other damage, no legal injury can result. The law, however, is otherwise. The decisions recognize that the right to maintain a reasonable system of accounting is in itself a legal right the deprivation of which will entitle a carrier to relief, if it can show that the order complained of exceeds the commission's authority or is wholly arbitrary or unreasonable. See *I. C. C.* v. *Goodrich Transit Co.,* 224 U. S. 194, 32 S. C. R. 436, 56 L. Ed. 729; *Kansas City So. Ry. Co.* v. *U. S.,* 231

U. S. 423, 440; 34 S. C. R. 125, 58 L. Ed. 296, 52 L. R. A. (N. S.) 1; also opinion below (Com. Ct.), 204 F. 641, 644; *Norfolk & Western Ry. Co.* v. *U. S.*, 287 U. S. 134, 143, 53 S. C. R. 52, 77 L. Ed. 218. In these cases the courts took jurisdiction and reviewed on their merits orders requiring a particular method of accounting."

In the *Norfolk & Western* case (287 U. S. 134, 138), the rules of the Interstate Commerce Commission required railroad companies to divide their assets into two general classes: namely, investment in road and equipment and miscellaneous or non-transportation property. The Norfolk & Western Railroad owned certain coal lands which it alleged were used exclusively for supplying coal as fuel for its locomotives. It insisted that those lands constituted an item of investment in road and equipment. The Commission held to the contrary and ordered that the property be included among the miscellaneous or non-transportation property.

The Court pointed out that few if any other railroads were situated like the Norfolk & Western with respect to its coal lands (p. 141); that uniformity of reporting for the purpose of comparing results would require that the Norfolk & Western keep its books in manner similar to those kept by the other railroads (pp. 140-141); and that the amount of return to which the company was entitled under the recapture provisions of the Transportation Act would not be affected because it would be given an opportunity in a recapture proceeding to present any claims with regard to the inclusion of the property (p. 141). Certainly in this case the railroad company failed completely to show that the order of the Commission was unreasonable, arbitrary or contrary to sound accounting principles.

In the *Kansas City Southern* case (231 U. S. 423) the railroad company built originally a road with heavy grades appropriate for the light traffic and trains of that period. Under the demands of heavier traffic it eliminated the heavier grades at some points by laying new sections of track at other points and abandoned the roadbed first constructed. It sought to include in its capital accounts the total amount spent for both the new tracks and roadbed and the abandoned roadbed and to ignore the fact that a substantial amount of mileage had been abandoned. The order of the Commission required that the cost of the abandoned track and roadbed be deducted from and that of the new track and roadbed be added to the capital accounts. So far from the order of the Interstate Commerce Commission concealing the facts or requiring improper accounting, that order required that all the facts be given effect to, the abandonment, as well as the new construction.

The court naturally and properly held that the order of the Commission was not unreasonable and not arbitrary.

Of course, when the new tracks were laid and the old roadbed abandoned, the railroad had nothing but the existing property. The abandoned roadbed had been retired from service.

The law is settled that the plaintiffs are entitled to relief, if the provisions complained of are outside the authority granted by the statute or are so arbitrary or unreasonable as to constitute an abuse of power. In the respects above stated we have shown these conditions exist.

Even a Chinese in the Philippines has a right to keep a truthful set of books, needed in his business to show his actual transactions.

Yu Cong Eng v. *Trinidad*, 271 U. S. 500.

V.

The provisions assailed are not severable and the whole order is void.

We believe that with the elimination of the provisions enjoined below and those assailed here,* the remainder of the accounting system is incomplete and unworkable. Large gaps appear in its structure. The eliminations leave many important matters unprovided for, with no rule to guide the accountants. The system is unworkable unless the gaps may be filled by the accountants by substituting provisions which in their opinion are consistent with sound accounting.

When we sought a stay pending this appeal this question was raised but left unsolved. The Justice of this Court who granted the stay applied it only to the provisions complained of, reserving in his order the right to consider a stay of the whole order if further application were to be made. Thereupon the Commission, apparently realizing that the gaps left in its system of accounts were serious, suspended the effective date of the whole of its Telephone Division Order No. 7-C, to await the decision of this Court. If our contentions are sustained, doubtless the Commission will consider it wise to fill the gaps with new provisions and fix a new effective date for the inauguration of the system in the manner prescribed by the statute. If it so declares its intention the Court will be relieved of the task of considering

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* This statement is not intended to embrace Instruction 2(B.1), respecting just and reasonable payments, nor the instructions as to contributions which were enjoined by the court below. We concede that these provisions are severable.

whether what is left of the system is separable and workable. If no such proposal is made by the Commission, we rest on our position that the system is incomplete without the provisions objected to.

Respectfully submitted,

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